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Mr. David S. Guzy, Chief
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Royalty Management Program
P. O. Box 25165, MS 3101
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Dear Mr. Guzy:

On behalf of the Rocky Mountain Oil & Gas Association (RMOGA), I am writing to offer comments on the Amendments to Gas Valuation Regulations for Federal Leases, published in the *Federal Register* on November 6, 1995, at page 56007. RMOGA is a regional trade association representing hundreds of members who account for more than 90% of the oil and gas exploration, production and transportation activities in the Rocky Mountain West, as well as the majority of onshore federal lessees and rental, bonus and royalty dollars paid to the federal treasury from onshore federal leases.

I would like to take this opportunity to express RMOGA's appreciation for our participation in this rulemaking process, first as a member of the Federal Gas Valuation Negotiated Rulemaking Committee (Reg-Neg Committee) and now in commenting on the proposed rule. RMOGA strongly supports the negotiated rulemaking process and the current proposed gas valuation rules. We believe this rule is a good example of the quality product that can be obtained through the negotiated rulemaking process. While there are concerns with certain provisions of the proposed rule, we believe the rule is as good a compromise as could have been obtained, given the sometimes diverse interests of the parties involved.

Moreover, we believe there are many advantages to be gained by promulgating the proposed rule. Some of the most significant benefits include those listed below:

- The proposed rule retains the ability to generally pay on gross proceeds, and the requirement for entitlements-based reporting for participants in unitization and communitization agreements, while providing several exceptions to those requirements which mitigate some of the problems associated with reporting and paying on entitlements that would otherwise be experienced by RMOGA's smaller independent producers.

- The proposed rule also provides an important new option, given the current natural gas marketing environment, to value production based on valid published indices, that will streamline reporting and simplify auditing of valuation for gas produced in designated zones that meet specified criteria.

- The proposed rule eliminates the burdensome requirement to file transportation and processing allowance forms.

- The proposed rule clarifies the definitions of compression, gathering and transportation, creating a "bright line" test that will reduce problems and conflicts upon audit.

- The proposed rule eliminates problems associated with the dual accounting requirement.

- And, the proposed rule permits an option to report the value of gas on a wellhead MMBtu basis that will eliminate costs associated with natural gas liquid (NGL) royalty payments.

For these reasons, RMOGA believes the proposed rule goes a long way toward greatly simplifying and streamlining the federal royalty payment and production accounting process as a whole, and will result in significant reductions in audit, enforcement, and litigation costs for both industry and government.

Even though RMOGA participated on the Federal Gas Valuation Negotiated Rulemaking Committee and, in the spirit of compromise, thereby agreed to provisions contained in the proposed rule, some questions and concerns have arisen among our members with respect to certain provisions which are addressed in the specific comments which follow. It should be noted RMOGA's comments are limited to <u>revisions to the existing regulations</u>, notwithstanding the fact that our members still have serious concerns with some of the provisions contained in the existing regulations.

Federal Register <u>Page Number</u>	<u>Section Number and Comment</u>
56016	<u>202.450(b) - *Gas subject to royalty.*</u> The proposed rule states "...except as provided in § 202.451(b), <u>in no instances</u> will any gas be approved for use royalty free downstream of the facility measurement point approved for the gas". This is an issue that was neither discussed nor agreed upon by the Reg-Neg Committee. RMOGA recommends eliminating this provision from the final rule. While there would be no revenue impact to

MMS, this provision will place an undue accounting burden on industry in having to distinguish between the uses of gas. Moreover, the determination of whether gas used is beneficial, and therefore royalty-free, is properly vested with the Bureau of Land Management. If BLM determines the gas is used for the benefit of the lease, no matter where the use occurs, it should be royalty-free.

56016 202.450(d)(ii) - *Agreements.* RMOGA enthusiastically supports the exception for small operating rights owners to report and pay royalties monthly on a "takes" basis, even if the total volume reported and paid for that lease for the month is less than the total volume of production allocable to the lease under an agreement. We further endorse the provision allowing qualified small producers in an agreement who have reported and paid on takes a six-month time period after the end of the production year in which to compare its total reported volumes on takes to its total entitled volumes and pay any additional royalty due at that time without incurring interest charges. These provisions level the playing field and serve RMOGA's small producers who otherwise would be required to report and pay on their entitled volumes each month.

56017 202.450(d)(iv)(C)(3) - Where the operating rights owner takes none of its entitled share of production and the production cannot be valued using an index-based method as if it had been taken, five benchmarks are proposed. RMOGA suggests changing benchmark number (3) — "the weighted average of the operating rights owner's gross proceeds under arm's-length contracts for that month in the field or area" — to number (1) and renumbering the remaining benchmarks accordingly. Using the current month's value in the field or area is much less complicated than having to average the last three months'; represents a more accurate value for that month; and will lessen the administrative burden for both MMS and industry. Therefore, reason dictates it should be the first benchmark. Further, if there are no sales for the immediate previous three months, which three months' prices are to be used? This particular contingency has not been but should be provided for in the proposed rule.

56018 202.452(b)(3) - *Standards for reporting and paying royalties on gas.* This section requires reporting NGLs in standard U.S. gallons, except for zones with an active spot market and valid published indices. This seems to be an unnecessary complication of the rule. NGLs may be sold on an MMBtu basis, and to report on an MMBtu basis better meets MMS' and industry's objective of reporting consistency. Moreover, consistent reporting on an MMBtu basis will eliminate confusion on the part of payors as well as the increased likelihood of reporting errors.

56020 206.451 - *Definitions.* Allowance - RMOGA recognizes that the proposed rule applies to gas produced from federal leases; however, it should be noted that the Reg-Neg Committee devised a broad, practical definition for transportation allowance that deserves further application. The Federal Gas Valuation Negotiated Rulemaking Committee's Final Report (Committee Report), at page 70, states: "The lessee may deduct from value, as a transportation allowance, the cost of moving royalty bearing substances (identifiable, measurable oil and gas, including gas that is not in need of initial separation)..." (emphasis added). Because this was a consensus of the Reg-Neg Committee, we request this concept be included in the MMS' oil valuation regulations definition of "marketable condition".

The proposed rule refers to Nominations Confirmed on page 56024, § 206.454(b)(3)(B) - *Weighted Average Index Value*, but fails to define the term.

The proposed rule defines "Operating Rights Owner", but fails to define Operating Rights.

Both are consequential terms that must be defined by MMS in order to diminish confusion and questions of interpretation.

56021 206.452 - *Valuation standards - unprocessed gas.* RMOGA clearly advocates the provision which eliminates comparison of index to a payor's own gross proceeds. However, we also recommend in § 206.452(b)(1) the reverse be stated, i.e., that the gross proceeds received by a payor not be compared to index. The regulations must firmly establish that one's own value will never be compared to an alternate methodology, except for the safety net calculation. Indeed, this was the consensus of the Reg-Neg Committee as stated on page 15 of the Committee Report, "For gross proceeds-based valuation, value will not be based on the higher of gross proceeds or index". Each valuation must stand on its own.

56023 — 206.454(a)(2)(iii) and (iv) - *Alternative valuation standards for unprocessed gas and processed gas. Applicability.* RMOGA recommends revising the last phrase in the first sentence of each of these two sections to read: "...including any applicable transportation allowance under § 206.457 ~~applicable to the residue gas~~." While this revision does not change the intent of the regulation, it will eliminate some confusion that the transportation allowance may only be applied to residue gas.

56024 — 206.454(a)(6) - This section deals with whether revenues received in connection with the reformation or termination of any gas purchase contract that occurred prior to the effective date of the proposed rule should be subject to royalty at the time a part of such revenue is attributed to later production. On page 56011 of the preamble to the proposed rule, MMS requests comments on treatment of settlements entered into after the effective date of the rule. It should be noted the Reg-Neg Committee agreed to exclude royalties paid on contract settlements from the safety net calculation. Moreover, when the Committee reached consensus on the concept of a safety net calculation, MMS agreed not to assess royalties on any other basis. Finally, the index based valuation method prohibits lessees from recapturing payments in excess of index value when index value exceeds the safety net median value.

Therefore, because we believe index prices are indicative of market value, RMOGA continues to support the position that additional royalties are not and should not be due on proceeds from gas contract settlements either before or after the effective date of this rule. Moreover, this issue was not addressed in the Committee Report and no consensus was reached by the Committee. Furthermore, this is a matter currently under litigation. Therefore, this section should be deleted from the final rule.

56024 — 206.454(b)(2)(ii)(A) - *Fixed Index Value.* RMOGA recommends revising the first sentence to read: "The fixed index value for the month is determined as follows:...determine the 12-month arithmetic average of the applicable monthly index prices...". This revision adds clarity and certainty to the rule and will eliminate later confusion.

56025 — 206.454(e) - *Additional royalty obligations.* - Industry strongly believes published index prices do provide market value for gas. During negotiations, industry indicated it did not feel there was need for a safety net calculation; however, this procedure was an unconditional requirement of MMS and the states in order for them to consent to a valuation based on index prices. Industry therefore agreed to the safety net in the spirit of compromise. If a safety net procedure is deemed necessary, RMOGA supports the current proposal and recommends it not be modified. RMOGA also recommends a review after four years to determine the necessity for continuing calculation of a safety net, perhaps with periodic "spot checks" to be conducted on a to-be-determined basis thereafter. There is no need to continue such an exercise if the necessity for doing so is not justified.

56025 206.454(e)(1)(i)(B) and (C) - RMOGA recommends revising the second phrase in both these sections to read: "...but only if any ~~the~~ associated gas plant products are valued under § 206.453". This revision will clarify that these provisions also apply to arm's-length non-dedicated unprocessed gas.

56025 206.454(e)(2)(v) - RMOGA members believe the references in this subsection should be "(e)(2)(i)-(v)" and "(e)(2)", respectively, and request clarification if that is not so.

56026 206.454(e)(6) - MMS has specifically requested comment on what the consequence should be if the agency fails to publish the final safety net median value within two years following the end of the calendar year. RMOGA members unanimously agree, should this occur, the index value reported by the payor should be deemed to be the value for royalty purposes and no additional royalty should be due. Failure to meet this critical deadline removes the certainty industry needs to meet its royalty obligations without incurring additional interest charges and/or penalties. Moreover, industry's consensus vote was based in part on MMS' assurance that this could be accomplished within two years.

56026 206.454.(e)(7) - RMOGA members have several questions regarding the convening of a technical procedural review (TPR) where the final safety net median value is disputed. How will notification to "all affected parties" be made? What happens if a company does not or cannot participate in the review and the value is later modified? Will all companies within a zone be notified of any modification to the safety net median value? RMOGA recommends MMS establish a policy setting forth the procedures to be followed for requesting and convening a TPR and for notifying all affected parties of such review and its results.

56026 <u>206.454(e)(8), (9) and (10)</u> - Each of these sections requires that "[t]he lessee must determine the weighted average...value" of production in order to determine any additional royalties that may be due based on calculation of the safety net median value. However, the Committee Report, on page 35, states "...MMS will calculate the lessee's weighted average index price paid net of allowances for the index year by zone". RMOGA requests clarification of MMS' intent.

56026 <u>206.454(e)(9)(ii)(B)</u> - This percentage should be <u>65</u>, as indicated on page 39 of the Committee Report.

56026 <u>206.454(e)(10)(ii)(B)</u> - This percentage should be <u>30</u>, as indicated on page 37 of the Committee Report.

56027 <u>206.454(g)</u> - If a zone is added or modified based on a technical conference will companies be allowed to make a new election based on the new zone? The proposed rule does not address this situation; however, RMOGA recommends companies be allowed the opportunity to make a new two-year election based on any new zone or modification to a zone since these modifications have the potential to change the basis on which a company's original election may have been made.

56028 <u>206.456 - *Transportation allowances - general.*</u> As discussed in the preamble, the Reg-Neg Committee employed the term "location differential" but in the proposed rule, the term "transportation allowance" is used for the same purpose. The term "location differential" was coined to distinguish between a company's actual costs for transportation and amounts that reflect a reasonable cost for transporting gas to the Index Pricing Point (IPP). RMOGA disputes the rejection of this term and recommends the term "location differential" be reinstated in the final rule and defined as approved by the Reg-Neg Committee: "Location differential (LD) means the transportation costs incurred or which would be incurred to get the gas from the well to the index pricing point".

56028 <u>206.456(a)(2)</u> - RMOGA supported the consensus proposal of the Reg-Neg Committee concerning compression during negotiations; however, after additional review of the regulations and discussion with our members, we believe a more practical and consistent approach could be taken. MMS might consider that compression occurring prior to the <u>separator</u>, rather than the facility measurement point (FMP), be considered non-deductible, and compression beyond the separator be considered deductible. This proposal still meets the "bright line" test methodology on which the Committee reached consensus, but would greatly simplify accounting for compression. The proposal also conforms this function of compression to MMS's definition of transportation and will minimize confusion with respect to the separate delineations for transportation and compression (since in the proposed rule these occur at different points).

56030/56032 <u>206.457(c)(2)(iv)(A) and 206.459(b)(2)(iv)(A)</u> - <u>*Determination of transportation allowances, and Determination of processing allowances.*</u> These sections provide that for transportation systems and processing plants, respectively, purchased by the lessee or the lessee's affiliate that do not have a previously claimed MMS depreciation schedule, the lessee may treat the transportation system or processing plant as a newly installed facility for depreciation purposes. RMOGA strongly advocates this treatment of depreciation for acquired facilities.

56032 <u>206.457 and 206.459</u> - General. The proposed rule does not distinguish between arm's-length and non-arm's-length transactions in reporting processing allowances and it is unclear whether allowance forms are eliminated for non-arm's-length transactions. RMOGA strongly supports the Committee recommendation (Committee Report, page 73) that all transportation and processing allowance forms be eliminated for both gross proceeds and index-based payors. Therefore, RMOGA recommends that, in keeping with its commitment to eliminate allowance forms, MMS must eliminate <u>all</u> transportation and allowance forms for <u>both</u> arm's-length and non-arm's-length sales in the final rule.

56033 <u>211.18(c)(3)</u> - <u>*Who is required to report and pay royalties?*</u> RMOGA explicitly endorses this provision, which allows companies an exception to report and pay royalties on their entitled share of production where all operating rights owners in an agreement can agree to assign reporting and payment responsibilities among themselves.

<u>Other Comments</u>

Generally, RMOGA recommends a clarification to the use of the single term "well" throughout the proposed rule. For example, what if a group of wells from a single gathering line is connected at the point at which IPPs exist? Page 18 of the Committee Report, *Index*

Pricing Point, states, "A single connect is where the IPP is established before the pipeline to which the well, lease, platform, central delivery point, or plant (collectively referred to as a well) is physically connected,..." (emphasis added). This is a concept that seems to have gotten lost in the proposed rule. We suggest clarifying in the preamble that the term "well" may refer to a well, lease, platform, central delivery point or plant, wherever used in these regulations.

RMOGA strongly supports the Reg-Neg Committee's recommendation that value for gas produced from agreements which contain only federal leases with the same royalty rate and funds distribution, and from leases not in an agreement (stand-alone leases), may be reported and paid on a "takes" method (Committee Report, page 63). However, RMOGA members noticed that the Committee's recommendation is not accurately reflected in the MMS' concurrent proposed rule on "Payor Liability". Specifically, the language in the Payor Liability rule excludes any exception for entitlements. We urge the Committee's recommendation be stated verbatim in the final gas valuation regulation as well as in the proposed Payor Liability rule to reduce any confusion that may arise where it could be construed that all payors will be required to pay on a pure entitlements basis, and so the issue will not be dependent upon adoption of the payor liability rules.

The proposed rule does not address exceptions for unique production such as coal seam gas and high sulfur gas, which bear unusually high costs of production and transportation. MMS must acknowledge these costs and consider a more equitable treatment for nonconventional gas, perhaps through an MMS-approved extraordinary cost allowance. RMOGA believes the Reg-Neg Committee should have considered this issue in the context of an allowance and not have restricted discussion to the concept of a separate zone.

The preamble to the proposed rule, at page 56009, requests comments on suggestions for improvements to the benchmarks for valuing gas sold under non-arm's-length contracts that cannot be valued based on an index. As acknowledged, the Reg-Neg Committee was unable to reach a consensus on improved benchmarks. However, it can be stated without qualification that RMOGA members, particularly those who engage in downstream pool-type sales, adamantly oppose any benchmark that includes an affiliate's arm's-length resale values. RMOGA generally recommends adoption of the industry-proposed benchmarks, which are captured in the Committee Report on pages 54-55. Industry's benchmarks establish value that is based on information readily available to the lessee associated with comparable sales.

Also in the preamble to the proposed rule, at page 56015, MMS requests comments on how best to accommodate supplementary reporting. RMOGA recommends all issues arising from these regulations that may require modification to reporting requirements, including supplementary reporting as well as reporting of NGLs [see RMOGA's comments on § 202.452(b)(3)], be referred to the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting. Clearly, this Subcommittee is the most appropriate venue for determining the most efficient, streamlined, accurate reporting methodology under the amended regulations.

Finally, RMOGA recommends MMS reconvene the Reg-Neg Committee should it become evident that the final gas valuation rule may differ substantially from the proposed rule, since a significant revision of the negotiated rulemaking should require reproposal of the regulations in draft form for additional comment by the public. The Reg-Neg Committee must make the determination whether the rule should be changed. Moreover, failure by MMS to publish the final rule essentially as it was negotiated could affect the credibility of this Administration regarding negotiated rulemaking.

Thank you for your consideration of our comments on this important regulation. If you have any questions or would like to discuss any of our comments in greater detail, please do not hesitate to contact me.

Very truly yours,

Carla Wilson

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Tax, Finance & Accounting